



EMERALD

EMERALD ADVISERS, INC. 2009 2ND QUARTER ECONOMIC & PORTFOLIO COMMENTARY

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BIG BOUNCE OFF LOWS

	<u>2nd Quarter 2009</u>
Russell 2000 Growth	23.38%
Russell 2000 Value	18.00%
S&P 500	15.93%

A flattening in the rate of deterioration in economic growth and stabilization of the financial system led to the substantial rally experienced from the March lows. With green shoots abounding during the quarter, market sentiment and outlook changed dramatically from that of early March. Extrapolation of the conditions experienced during the dramatic Q4 slowdown, as reflected in the market decline during January and February, proved to be too severe as the quarter progressed. Not only was the depression scenario pulled off the table, but the recession, which has now stretched in excess of 20 months, was viewed to be closer to the end than the beginning. As a result there was a dramatic shift in risk aversion and a swift adjustment in valuations.

As the equity market rallied, credit spreads continued to narrow. The simultaneous occurrence of these two events led to the reopening of the capital markets. After being frozen during the last quarter of 2008 and the first quarter of 2009, credit began flowing again. As a matter of fact, there were 38 high-yield bond deals completed in June, which was the highest level since May 2007, according to Merrill Lynch. The financials alone raised in excess of \$80 billion dollars.

Emerald believes the reopening of the capital markets was one of the more defining factors of this market recovery and the composition of returns witnessed during the second quarter. In that regard much has been discussed regarding what is being deemed as a low quality rally. Low quality is being defined as smallest market capitalization, lowest ROE and highest debt-to-capital ratios posting the best performance within the Russell 2000, by in some cases a substantive margin, as illustrated in the charts below.

Performance by Market Cap – stocks over \$1 Billion are lagging behind (Source: Bank of America Merrill Lynch)

<u>Market Cap Bucket</u>	<u>Russell 2000 Growth 2Q Return</u>
>1 BILLION	10.63%
>500 MIL, <=1 BIL	23.82%
>250 MIL, <=500 MIL	31.65%
<=250 MIL	48.74%

Performance by stock price (Source: Bank of America Merrill Lynch)

<u>Stock Price</u>	<u>Russell 2000 Growth 2Q Return</u>
<=5	47.91%
>5, <=10	37.66%
>10, <=20	24.72%
>20	13.04%

Performance by P/E quintile (Source: Bank of America Merrill Lynch)

<u>P/E Quintile</u>	<u>Russell 2000 Growth 2Q Return</u>
Q1 (lowest)	44.88%
Q2	26.21%
Q3	19.39%
Q4	13.66%
Q5 (highest)	18.25%
Non-earnings stories	33.38%

Performance by ROE quintile (Source: Bank of America Merrill Lynch)

<u>ROE Quintile</u>	<u>Russell 2000 Growth 2Q Return</u>
Q1 (highest)	19.05%
Q2	21.10%
Q3	24.05%
Q4	29.25%
Q5 (lowest)	32.95%

As outlined in the charts above, the spoils in terms of second quarter returns was awarded to those companies that had suffered most during the downturn. These companies were in many instances on the brink of breaching debt covenants and were being priced as if bankruptcy/insolvency was the most probable outcome. With such negative sentiment, the ability to successfully renegotiate debt covenants and/or raise new capital was received very positively by the marketplace. As such these once very risky assets, which had undergone significant multiple contraction as a result of leverage on their balance sheets, experienced a rapid and material recovery in their multiples.

This low quality rally proved to be very difficult for active managers to navigate. Merrill Lynch noted that less than one third of small cap growth managers managed to beat their benchmarks during the quarter. Beside the low quality and smallest stocks dominating the performance of the index for the quarter, the breadth of the rally across the major economic sectors, made it difficult to outperform and prevented stock pickers like Emerald from gaining ground.

While the dynamics of this rally certainly presented challenges during the second quarter, we do not believe that the variation in performance among the index constituents that has been prevalent since the March bottom is sustainable. The adjustment to valuations driven by stabilization of the world financial system and economic growth has largely taken place. Therefore while "less bad" and "stabilization" have been enough to support the market's move to date, additional improvement on both the economic and earnings front are needed in order to sustain the upward momentum in the market. There have been glimpses of what we would view to be normalization over the last few weeks as the pace of market improvement has slowed from the levels experienced in April. As that has occurred Emerald's relative performance has improved. We believe this is the part of the cycle where the fundamentals should garner more focus, breadth should narrow and earnings growth should be rewarded.

Portfolio Review

After relative outperformance in the first quarter, fortunes reversed during the second quarter, as Emerald's performance trailed that of the benchmark. From a macro perspective, as discussed previously, the composition of the market returns (smaller market cap, lower P/E, lower ROE, etc.) was a headwind. Specific to Emerald's portfolio, performance was constrained by a

combination of disappointing performance within healthcare, lack of exposure to producer durables and materials, and the lack of contribution from top portfolio holdings.

Healthcare performance was the most disappointing aspect of the quarter, primarily as a result of stock selection. From a portfolio positioning perspective, after being very bullish on healthcare given the sector's relative growth prospects, Emerald moved to an underweight position at the end of the first quarter as the concerns mounted regarding the impact of both healthcare reform and the lingering recession (i.e. lower hospital cap-ex due to financial constraints, lower patient volumes) on the earnings outlook for the sector. This proved to be the correct decision as healthcare was one of the worst performing sectors during the second quarter returning 18.02% relative to 23.4% for the index overall. However, stock selection was disappointing. First, Emerald was focused on those companies with approved products and earnings. Similar to what was witnessed in the index overall, these "higher" quality companies did not experience the same level of appreciation experienced by the pre-product companies, pressuring relative performance. Further, negative contribution from stock selection within biotechnology and three positions, in particular, accounted for over fifty percent of the shortfall relative to the benchmark.

Looking forward, we anticipate that performance within the healthcare sector will remain muted until there is greater clarity made available on the healthcare reform initiatives as well as better visibility on the resumption of hospital capital spending. That being said we do see opportunity in the area of healthcare information technology, in front of the implementation of electronic health record mandates and we have been adding companies we believe will benefit.

The underperformance in materials and producer durables was driven by the portfolio's underweight position as well as the lack of participation from the largest positions held within these sectors. The impact of the collective underweight position was magnified as a result of their outperformance. The materials component of the Russell 2000 Growth gained in excess of 30% and the producer durables sector gained in excess of 27%, well outpacing the Russell 2000 Growth index return of 23.77%. In particular the lack of exposure to the most cyclical industries within the sectors was detrimental to relative performance. These industries included: building materials, metal fabrication, aerospace, and industrial machinery. The decision to be underweight these industries early in the second quarter was driven by our expectations for further negative earnings revisions and weak relative earnings growth expectations. Estimates for the materials sector for the second quarter are anticipated to decline in excess of 70% year over year, which is significantly weaker than the 45.4% decline expected for the Russell 2000 overall. Given the relatively better growth outlook within technology and consumer discretionary, the portfolio had a greater emphasis on those two sectors. Compounding the lack of exposure was the lack of participation of the largest holdings within both of these sectors. Although the portfolio was underweight during the second quarter, as the quarter progressed and earnings estimates were revised to what Emerald viewed to be more realistic levels, we have been selectively adding to the portfolio's materials and producer durables exposures.

While this quarter's relative performance was disappointing, there are some positives that should be noted. First, technology remains the strongest sector within the Russell 2000 Growth for the year-to-date and Emerald has experienced solid outperformance driven by both the portfolio's overweight position and stock selection within the communications and semiconductor industries.

Positions in the semiconductor industry benefited broadly as Asian channel checks suggest that semiconductor demand and pricing is stabilizing in some end-market areas, including: telecommunications benefiting from the China 3G build out; the continued transition to higher performance netbooks; and certain consumer product areas including LCD TVs. Despite continued weak order visibility, there is improving confidence for demand improvement during 2H-09. For Q2, we expect the semiconductor manufacturer group will post a 6% to 10% sequential increase in revenues. Because most manufacturers took actions to lower operating cost during this downturn, we believe many manufacturers are positioned to restore earnings on lower revenues, and will be well positioned as revenues increase from an economic recovery in 2010 and beyond. We continue to focus on manufacturers with non-cyclical growth drivers.

Emerald has been positive on technology since the middle of the first quarter, believing that consensus estimates for 2009 were too low. The portfolio remains overweight and we remain optimistic regarding the opportunity within the technology sector. Further, consumer discretionary performance, while a slight negative relative contributor to return, showed positive stock selection. The portfolio, after being underweight the consumer discretionary sector since the third quarter of 2007, is currently equal-weight given what we believe to be an attractive opportunity set. Further as stated above, the portfolio is now currently overweight the materials sector and well positioned if the cyclical recovery continues to gain momentum.

Market Outlook

Since the release of the June jobs report much of the market's attention has been focused on the wilting of those green shoots that were talked so much about throughout the second quarter. We however remain optimistic. Consumer and business confidence appears to have bottomed and while unemployment is likely to worsen further, the worst of the declines are likely behind us. Manufacturing indicators are moving in the right direction, and the stimulus is still forthcoming. Further as we move into the second half, earnings should show relative improvement driven by easing comparisons and operational/expense initiatives implemented year-to-date.

The housing environment, however, remains challenging. While the Case Shiller data has shown stability, anecdotal evidence appears mixed. Pre-foreclosure numbers are unknown and our recent meeting with a leading national homebuilder indicated that improvements are modest in nature and isolated to only a few regional markets. In addition, the industry remains challenged by the ability of consumers to access financing, a soft pricing environment, and a sizable number of financially troubled small homebuilders. That being said we still expect housing will bottom in early 2010.

As we look toward the second half of 2009, we believe the steepening of the yield curve and the narrowing of credit spreads are foretelling of an improving environment for equities. If the macro-economic environment continues to show improvement as we believe it will, the under-funding of pension plans and the enormous amount of cash on the sidelines leads us to believe cash flows will favor equities over the next 12 months. Once stimulus is spent and the Federal Reserve has to withdraw from the system to prevent runaway inflation, we expect a more difficult environment will present itself in late 2010. Only a renewal of organic growth will cause us not to be concerned about sub par growth, a lower dollar and the effects of inflation in future years.

After a very challenging second quarter, where performance suffered on a relative basis, we do not believe that the market dynamics that were in play during the quarter are sustainable (smallest market, lower ROE, higher debt-to-capital ratio stocks outperforming). With the bulk of the valuation adjustment behind us, earnings growth is more likely to be a focal point moving forward. As such we believe that this is the part of the cycle where the fundamentals should garner more focus, breadth should narrow and earnings growth should be rewarded. To that end we remain focused on finding the best opportunities in the universe in which we invest.

Top Ten Holdings (by Market Value)

1	Neutral Tandem (TNDM)	2.31%
2	SBA Communications (SBAC)	1.96%
3	Marvel Entertainment (MVL)	1.95%
4	Ansys, Inc. (ANSS)	1.87%
5	ViaSat, Inc. (VSAT)	1.81%
6	GSI Commerce (GSIC)	1.67%
7	Iconix Brand Group (ICON)	1.67%
8	Bio-Reference Labs (BRLI)	1.63%
9	99 Cents Only Stores (NDN)	1.60%
10	Mariner Energy (ME)	1.52%

Portfolio Characteristics

	<u>Emerald</u>	<u>Russell 2000 Growth</u>
Proj. Growth Rate (3-5-Year)*	17.2%	16.8%
P/E Ratio**	19.6x	17.4x
R2 vs. Russell 2000 Growth	0.96	---
Yield (%)	0.28	0.61
Price/Book Value**	2.3x	2.7x
Median Market Cap (By No. of Stocks)	\$958 mm	\$349 mm
Wgt. Average Market Cap	\$1,283 mm	\$830 mm
Turnover (annual)	103%	

* Database Estimate, Emerald's internal estimates are higher.

** In order to better reflect Emerald's characteristics relative to the Russell Indices, Emerald is now calculating its P/E and Price/Book ratios based on a weighted harmonic average in line with Russell's calculation methodology.

Sector Allocation

	<u>Emerald</u>	<u>Russell 2000 Growth</u>
Auto & Transportation	2.9%	2.7%
Consumer Discretionary	18.4%	21.1%
Consumer Staples	3.0%	2.7%
Energy	3.1%	3.3%
Financial Services	7.3%	7.7%
Healthcare	19.3%	24.6%
Materials & Processing	6.3%	5.3%
Producer Durables	5.5%	7.4%
Technology	28.6%	22.9%
Utilities	3.3%	2.0%
Other	0.0%	0.5%
Cash	2.3%	0.0%

-July 17, 2009